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Surplus Mania: A Reality Check

L. Randall Wray

A federal government surplus has finally been achieved, and it has been met with pronouncements that it is a great gift for the future and with arguments about what to do with it. However, the surplus will be short-lived, it will depress economic growth, and, in any case, surpluses cannot be “used” for anything.

According to President Clinton's State of the Union address, we are on a course to run federal government budget surpluses for the next 15 to 25 years. He proposes that we set aside most of the surpluses for the future and use 62 percent to rescue Social Security, 15 percent for Medicare, and 12 percent for Universal Savings Accounts. The publicly held debt would be cut by more than two-thirds, dropping the debt-to-GDP ratio from 44 percent today to just over 7 percent by 2014—heralded as “its lowest level since 1917”—and completely eliminating publicly held debt by 2018.

The plan was well received. A number of prominent economists, including six Nobel winners at last count, have been circulating an open letter dubbing the president's plan “good economics” and stating that “Although no one can predict how large the budget surpluses will turn out to be, we can be sure that saving them by reducing outstanding government debt is an excellent way to ease the burden on future workers of supporting an aging population.” In “Saving the Surplus Will Protect Retirees” (*Wall Street Journal*, February 18, 1999), Lawrence Summers, deputy secretary of the Treasury, and Janet Yellen, chair of the President's Council of Economic Advisers, assured us that the president's proposal to “lock away” most of the projected budget surpluses in the Social Security Trust Fund is based on “sound accounting” and that it will extend Social Security's solvency through 2055. David

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Broder's *Washington Post* article (February 7) proclaimed the plan to be "the greatest gift to our children" because it will "help grow the economy" by "raising national savings."

Essentially, the president's plan would use about three-fourths of projected surpluses to retire Treasury debt held by the public, but would then issue new, nonmarketable Treasury debt to be held in the Social Security Trust Fund. Unfortunately, the accounting is not sound, and a policy that would preserve surpluses in an attempt to retire Treasury debt held by the public is anything but a gift to our children.

Reality Check

The federal government has been in debt every year but one since 1776. Far from viewing government debt as a horror to be avoided, at least some of the founding fathers recognized the benefits. Thomas Paine proclaimed that "No nation ought to be without a debt" for "a national debt is a national bond." Alexander Hamilton asserted that "A national debt, if it is not excessive, will be to us a national blessing." Andrew Jackson, however, labeled the public debt a "national curse" and, like President Clinton, set out to retire it. By January 1835, for the first and only time in U.S. history, the public debt was retired, and a budget surplus was maintained for the next two years in order to accumulate what Treasury Secretary Levi Woodbury called "a fund to meet future deficits." In 1837 the economy collapsed into a deep depression that drove the budget into deficit, and the federal government has been in debt ever since.

Since 1776 there have been six periods of substantial budget surpluses and significant reduction of the debt. From 1817 to 1821 the national debt fell by 29 percent; from 1823 to 1836 it was eliminated (Jackson's efforts); from 1852 to 1857 it fell by 59 percent, from 1867 to 1873 by 27 percent, from 1880 to 1893 by more than 50 percent, and from 1920 to 1930 by about a third. The United States has also experienced six periods of depression. The depressions began in 1819, 1837, 1857, 1873, 1893, and 1929. Every significant reduction of the outstanding debt has been followed by a depression, and every depression has been preceded by significant debt reduction. Further, every budget surplus has been followed, sooner or later, by renewed deficits. However, correlation—even where perfect—never proves causation. Is there any reason to suspect that government surpluses are harmful?

At the macroeconomic level, government expenditures generate private sector income; taxes reduce disposable income. When government spending exceeds tax revenue (a budget deficit), there is a net addition to private sector disposable income. This addition may well have secondary and tertiary and even further effects (for example, households may spend on goods produced domestically or abroad, thereby raising consumption or imports as measured in national GDP accounts). When the Treasury sells bonds, some of that extra disposable income is devoted to saving, accumulated as private sector wealth held in the form of government debt. Even if the Treasury did not sell the bonds, however, the private sector would be wealthier by an amount equal to the government's deficit, but this would be held in the form of non-interest-earning cash (and bank

reserves) for the simple reason that the total value of checks issued by the Treasury to finance expenditures would exceed the total value of checks written by the private sector to pay taxes.

When someone in the private sector receives a Treasury check, the check is deposited in a private bank, whose reserve account at the Fed is credited; at the same time the Treasury's deposit at the Fed is debited. When someone in the private sector writes a check to pay taxes, the taxpayer's bank deposit is debited; at the same time the Fed credits the Treasury's deposit and debits the private bank's reserves. When depositors withdraw cash from banks, the banks' reserves are reduced as the Fed issues currency. The sale of Treasury bonds also reduces bank reserves because bond buyers pay with checks drawn on private banks, which leads the Fed to debit bank reserves and credit the Treasury's deposit.

In this way government deficits result in a net increase to bank reserves and cash held by the public. Most of this increase is then drained as the Treasury sells bonds. In other words, government deficits always add disposable income and wealth to the private sector; the income is received first as a Treasury check and then may be transformed into an interest-earning government debt.

On the other hand, when tax revenues exceed government spending (a budget surplus), private sector disposable income is reduced. Again, there may be further effects (consumers may cut back spending, for example). Because checks received by the Treasury exceed the value of checks issued by the Treasury whenever there is a surplus, outstanding cash and bank reserves will be reduced. To restore cash and reserves, the private sector sells Treasury bonds. The bonds are purchased by the Fed and the Treasury; the purchase restores reserves and cash. (Sales of bonds between private sector entities cannot add reserves or cash; they simply shift reserves and cash from one "pocket" to another.) Note that if the Treasury refused to buy the bonds (that is, refused to retire outstanding debt), then only the Fed would be left to buy them. This is why any sustained surpluses *must* be met by Treasury retirement of the debt, for otherwise the Fed would accumulate vast holdings of Treasury debt (on which the Treasury pays interest) while the Treasury would hold huge deposits in its checking account at the Fed. (In practice, the Treasury tries to end each day with a deposit of \$5 billion.)

Movements of the budget position are largely automatic. Rapid economic growth, such as that experienced in the United States since 1992 or in Japan previous to 1990, tends to cause tax revenues to rise faster than government spending, resulting in surpluses. Recessions and depressions tend to cause tax revenues to fall as spending rises, resulting in deficits. Many economists focus on the secondary or tertiary effects of government deficits and surpluses. While they might agree that deficits increase disposable income and private sector wealth, they argue that deficits also increase interest rates and thus depress investment or that households reduce consumption on the expectation that tax rates will be increased in the future. They argue that while surpluses might reduce

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disposable income and private sector wealth, they also lower interest rates and thus spur private capital formation. While I believe these arguments are based on faulty reasoning, it is possible that under some conditions the secondary effects might outweigh the primary effects so that, at least for a while, deficits might depress the private sector and surpluses might stimulate it. However, history suggests that over the longer run, deficits stimulate the economy and surpluses are harmful.

Deficits and Growth; Surpluses and Stagnation

If, as projected, the federal government continues to run surpluses (resulting in Treasury debt retirement), this must as a matter of course remove \$4.5 trillion of private sector wealth over the next 15 years. Can an economy withstand such a bloodletting? Our own history suggests not, and we can also look to the recent experience of Japan.

The Great Depression followed persistent surpluses in the 1920s. Real GDP fell from \$791 billion (1929\$) in 1929 to \$577 billion by 1933. What is often not recognized is that real GDP then grew to \$832 billion by 1937. In real terms, this is the second-fastest growth in this century, topped only by the World War II boom. However, the rapid growth caused the budget to move from deficit to surplus by 1937, which then caused real GDP to fall to \$801 billion in 1938. As growth turned

negative, a deficit was restored and GDP began to grow again. At the end of the 1930s and the beginning of the 1940s private demand grew robustly (partly due to wartime demand), which again moved the budget to surplus. This time, however, unprecedented wartime deficits led to the fastest real growth of this century; real GDP grew by 50 percent between 1941 and 1944. After the war, from 1945 to 1947, deficits declined and GDP fell by 12 percent; the drop in 1946 rivaled that of the worst year of the Great Depression.

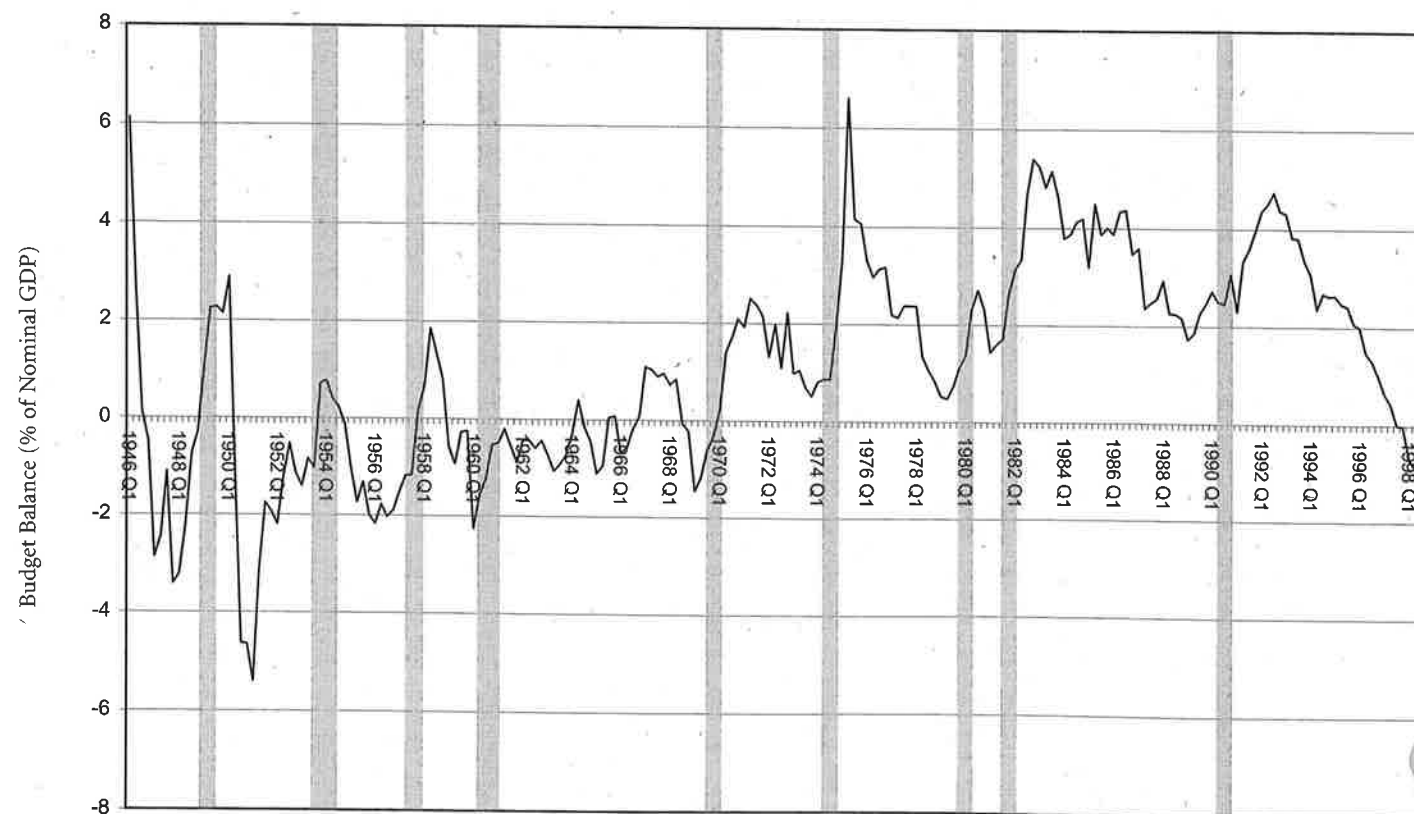
The economy emerged from World War II in 1945 with a record debt-to-GDP ratio. Since the war we have had the longest depression-free period in the nation's history. We have, however, had nine recessions, each of which was preceded by a reduction of deficits relative to GDP (see Figure 1). The deficit fell rapidly toward the end of the Carter presidency, preceding the deepest recession since the Great Depression. In spite of President Reagan's pledge to balance the budget, he presided over the largest deficits we had seen since World War II. To some extent, the deficits grew because of the economic slowdown; however, tax cuts and spending increases (primarily for defense) caused a discretionary increase of the deficit. The "Reagan boom" lasted from November 1982 to July 1990, the longest expansion in the postwar period (unless it is surpassed by the current expansion). Predictably, this reduced the deficit relative to GDP and preceded the Bush recession. In the early years of the Clinton presidency, the deficit grew again and was projected to continue. However, as a result of the long expansion and budget agreements, the deficit was entirely eliminated last year, and we experienced our first budget surplus in a generation.

Americans know that Japan's growth rate in the 1980s was the envy of the world, but they are generally unaware that the government deficits as a percent of GDP rivaled those in the United States. The enormous growth of the 1980s caused government tax revenue to rise faster than spending so that by 1990 the budget moved to surplus. The Japanese economy moved into a recession-cum-depression from which it has not been able to recover. Government deficits have been restored, but as a result of the sluggish economy, not as a result of discretionary, expansive, fiscal policy. While there have been some small initiatives to cut taxes and increase government spending, Japan has relied on monetary policy. For the second time in a year, Japan is pushing interest rates essentially to zero in an attempt to stimulate the economy. To this point, the most expansive monetary policy the world has seen since World War II still has not succeeded in jump-starting Japan's economy. This might serve as a cautionary tale for those who believe that Chairman Greenspan can keep the U.S. expansion going in spite of budget surpluses that are expected to rise well above 2 percent of GDP early next century.

Can a Surplus Be "Saved"?

Gertrude Stein once said of the city of Oakland, "There is no there there." Those who believe that a surplus can be "saved" for the future or "used" to finance tax cuts or spending increases do not understand the nature of a surplus. There is no "surplus" there for the purpose of "saving" or "use." A surplus is measured as a flow, with tax receipts over the year greater than government spending. The stock or balance sheet implication is that outstanding government debt (whether

Figure 1 Surpluses and Recessions—the Postwar Evidence



Note: Signs are reversed. A deficit is therefore given a positive value and a surplus is given a negative value. Data are from Haver Analytics Inc. Shaded areas indicate recessions.

that be in the form of cash, bank reserves, or interest-earning debt) is reduced. If the government were to retire all the outstanding debt and then continue to run surpluses, these could be accumulated only in the form of claims on the private sector (that is, private sector indebtedness). During any period the government can always choose to spend more (or less), in which case the surplus over the period may be lower (or higher); similarly, it can increase (or decrease) taxes, in which case the surplus may rise (or fall).

Of course, the impact of such fiscal changes on the surplus will depend in a complicated way on the secondary, tertiary, and further impacts discussed above. The conventional thinking that underlies all the projections is that surpluses have positive impacts on private sector saving, investment, and growth. But whether or not that is true, it is irrelevant to the discussions about "what to do with the surplus." The president's plan calls for most of the projected surpluses to be used for debt retirement (as, by definition, they must) with a percentage of this then matched by creation of new Treasury debt to be held by Social Security. In other words, the projected surpluses have nothing to do with "rescuing" Social Security except to provide a number that can be used to calculate how much new debt should be created so that the government can owe itself. The president could just as easily have proposed that we immediately create a nonmarketable Treasury liability equal to the entire discounted Social Security shortfall and stick that in the Trust Fund today. Or, he could have proposed that we do this in 2020 or whenever Social Security revenues fall short of spending. And there is no reason to "rescue" Social Security only through 2055; if a nonmarketable Treasury IOU can save it, we can save it through 2075 and beyond right now by giving it an IOU worth quadrillions to be cashed in as necessary.

When Social Security runs short and needs to start cashing in its quadrillions, its deficit will add net spending to the rest of the government's budget. Whether that budget is balanced or in deficit or in surplus, there will be some amount of total government spending (including Social Security) and some amount of total tax revenue (including payroll taxes) that will result in a fiscal stance that will generate secondary, tertiary, and so forth effects on the economy. The quadrillions held by Social Security will change none of this in any way. In spite of the claim by Summers and Yellen that "locking away" surpluses to save Social Security is "sound accounting," it is actually nonsense.

Conclusions

It is difficult to take seriously any analysis that begins with the projection that our government will run surpluses for the next 15 or 25 years. Part of our skepticism comes from the inherent difficulty in making projections. Summers and Yellen note, "Today, the U.S. debt held by the public is \$1.2 trillion less than was projected in early 1993." A projection made just six years ago missed the mark by more than a trillion dollars. A few trillion here and a few trillion there can really add up to big errors over a couple of decades.

Even more important, our economy cannot continue to grow robustly as the government sucks disposable income and wealth from the private sector by running surpluses. When the economy

slows, the surpluses will disappear automatically—and because the private sector will eventually demand that the government stop draining income from the economy. Tax cuts will be rushed through Congress and the president will put forward spending initiatives.

Finally, surpluses, even if realized, cannot be "locked away" for future use by retiring baby boomers. In every period that government spending falls short of tax revenues, outstanding government debt is retired. Equivalently, the private sector's stock of wealth is reduced (since a budget surplus reduces disposable income, and this shows up as a reduction of government debt in private portfolios). There is simply no "surplus" that can be "spent" or even "saved." Should the government decide to spend more, that simply increases spending relative to taxes and results in a smaller budget surplus. When total federal government revenue falls short of expenditures (including those associated with Social Security), the Treasury will issue new debt to the public to cover the difference. But it must do this whether or not there is a Trust Fund. Neither budget surpluses over the next 15 years nor accounting fictions can change that simple fact. There may be good (noneconomic) reasons for keeping Social Security accounts separately from the rest of the budget, but this should never lead one to believe that a revenue shortfall can be cured by having the government issue IOUs to itself.

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Related Publications

For additional Levy Institute research on this subject, see:

- David Alan Aschauer, *How Should the Surpluses Be Spent?* Policy Note 1998/2
- Dimitri B. Papadimitriou and L. Randall Wray, *What to Do with the Surplus: Fiscal Policy and the Coming Recession*, Policy Note 1998/6
- L. Randall Wray, *The Emperor Has No Clothes: President Clinton's Proposed Social Security Reform*, Policy Note 1999/2

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